

Choongsoo Kim: The prospects for the Korean economy in 2011

Keynote speech by Mr Choongsoo Kim, Governor of the Bank of Korea, at the Seoul Foreign Correspondents' Club (SFCC), Seoul, 13 December 2010.

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I. International and domestic economic conditions

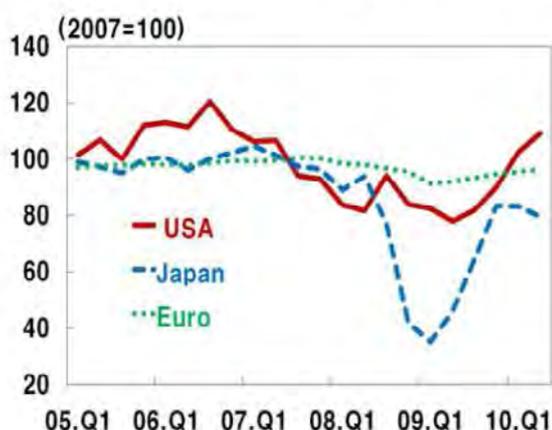
1. International conditions

World economy

Although the underlying recovery of the world economy is still on track, there seems little sign of any narrowing of the gap between the advanced countries and the newly emerging countries in what has been termed the two-speed global recovery¹.

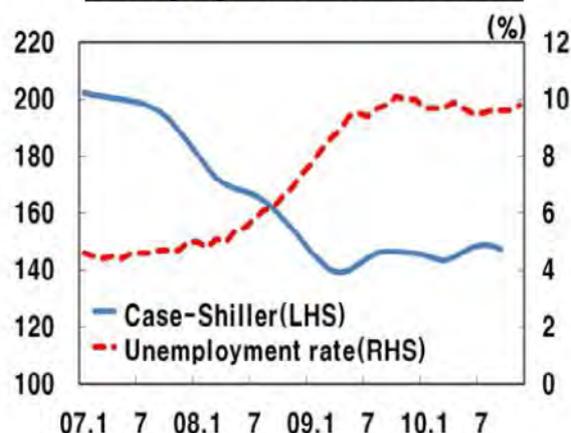
- **(USA)** The macroeconomic policy stance of pump priming activity has been maintained for example by means of QE2, and the scale of the increase in facilities investment has widened because of the upturn in firms' profitability.
 - We are unlikely, however, to see any great strengthening of the recovery momentum as a recovery in the labor and housing markets is yet to be seen while improvements in the saving rate continues.

Corporate profits in major countries



Source: OECD (Nov.2010)

House prices and unemployment rate in USA



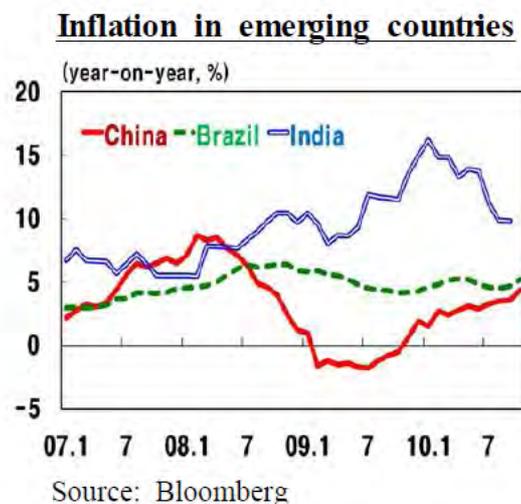
Source: Bloomberg

- **(China)** Shrugging-off the mildness of the recovery in the advanced countries, the Chinese economy has maintained its strong growth trend on the basis for domestic demand in line with the large scale of the rise in incomes and the measures² to promote consumption.

¹ Ben Bernanke, Rebalancing the Global Recovery (November 19); Masaaki Shirakawa, Advanced and emerging economies – two speed recovery (November 23).

² Payments to assist in the purchase of white goods are expected to be made up until January 2013 and, in accordance with the new economic plan for 2011–2015, social security expenditures are likely to be greatly increased to safeguard public welfare.

- Consumer prices and asset prices seem set to show unstable movements as the increase in liquidity by way of foreign capital inflows comes on top of the demand pressures from the high growth rates.

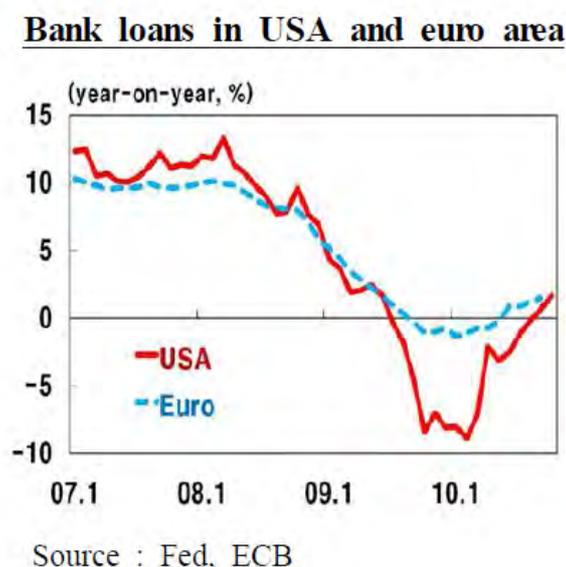
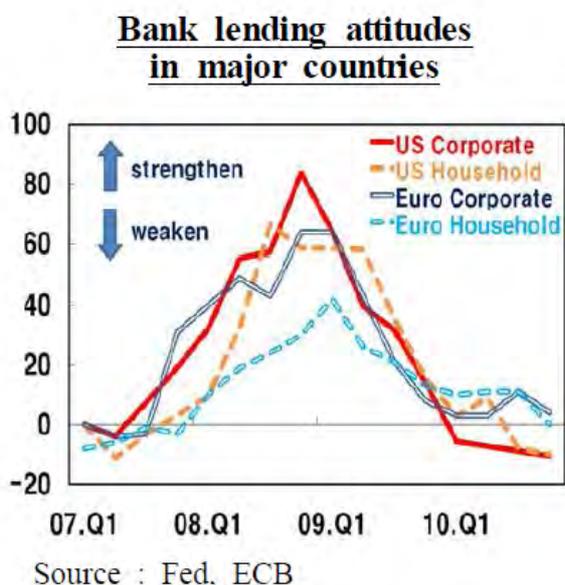


⇒ The major economic forecasting institutes are predicting that the rate of growth of the world economy will be a little above 4% in 2011 and around 4 1/2% in 2012.

Global financial markets

Globally, credit conditions are forecast to continue their improving trends owing mainly to the accommodative monetary policy stance of the major advanced countries.

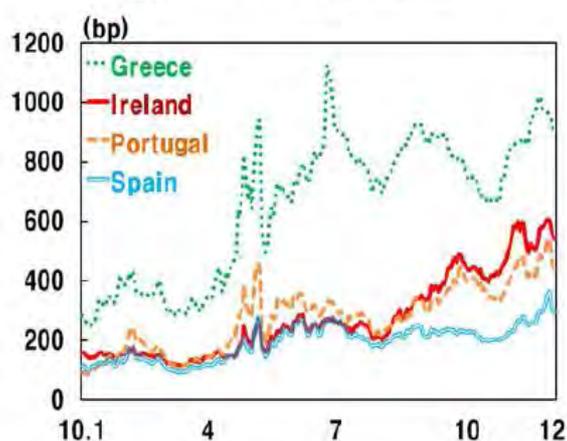
- For the US and the eurozone, bank lending has shifted to an increase since this September.



The other side of the coin is that global financial market uncertainty is on the rise because of euro area's debt problems and additional quantitative easing.

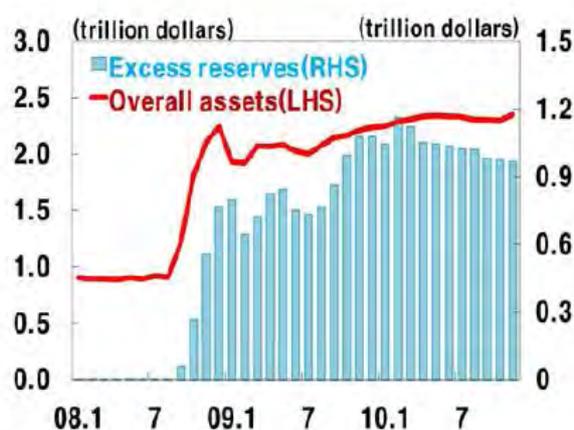
- **(Euro area debt problems)** Despite the funding support from the EU and the IMF, the sovereign debt problems of certain EU member states are likely to act as a factor making for market unrest for a considerable time to come.
 - If eurozone debt problems do worsen, there is the possibility that the credit risk of newly emerging market countries would also increase owing to a strengthened preference for safe haven assets.
- **(QE2)** The global financial markets are likely to react extremely sensitively to the direction of the US Fed's monetary policy ahead of the expiry of the second quantitative easing at the end of next June.
 - Market attention may well focus on whether or not there will be further quantitative easing (QE3).³

CDS premium in countries with fiscal problems



Source: Bloomberg

FRB's overall assets and excess reserves



Source: FRB New York

Commodity markets

International oil prices are forecast to maintain their upward trend in line with the continued recovery of the world economy and the increase in global liquidity.

- Next year demand for crude is likely to surpass supply albeit only by a small margin, led by the emerging market countries (+500,000bpd).
 - The fact that the OECD countries' oil inventories are now at their highest level since 2005 will act as a factor limiting the scale of upward movement in the oil price.
- Global liquidity, which has expanded greatly in line with QE2, could put upward pressure on oil prices if it feeds through into commodity markets.

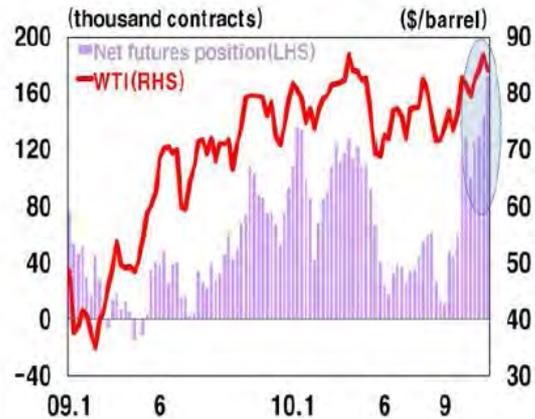
³ In the announcement of the Federal Reserve's FOMC for November, mention is made of the possibility of additional steps in accordance with future economic activity.

Outlook for supply and demand of crude oil

	(million bpd)		
	2009	2010	2011
Demand(A)	84.3	86.3	87.8
OECD	45.4	45.7	45.7
Non-OECD	38.9	40.7	42.1
Supply(B)	84.4	86.3	87.3
OPEC	33.9	34.8	36.1
Non-OPEC	50.5	51.5	51.2
Gap(A-B)	-0.1	0.0	+0.5

Source: IEA

WTI net futures position



Source: Bloomberg

2. Domestic conditions

Fiscal spending

Budgetary expenditures next year will be increased 6.0% over this year (260 trillion won) to 276 trillion won while for the year 2012 there will be a 4.0% increase to 287 trillion won.

- The extent of the front-loading of fiscal spending during the first half of 2011 will be gradually scaled back so that around 2012 it will be back to its pre-crisis level.⁴

The ratio of the fiscal deficit to GDP will decline from 1.9% this year to 1.6% in 2011 as tax revenues increase⁵.

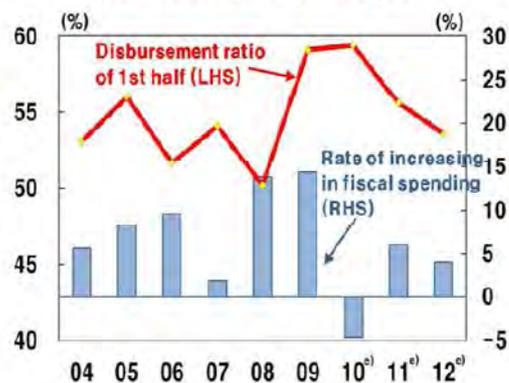
- The sovereign debt ratio will decline from 36.1% this year to 35.1% next year.

Fiscal balance outlook

	(trillion won, %)		
	2010	2011	2012
■ Fiscal spending ¹⁾	260.3 (-4.6)	275.8 (6.0)	286.8 (4.0)
■ Fiscal balance ²⁾	-21.6 [-1.9]	-20.0 [-1.6]	-10.6 [-0.8]

Notes : 1) Figures in () represent the rate of year-on-year increase
2) Figures in [] represent fiscal deficit/nominal GDP

Disbursement ratio in the first half of year



⁴ For the years 2004–07, the front loading of expenditures during the first half averaged 53.7%.

⁵ The government intends to achieve a balanced budget by 2013 or 2014.

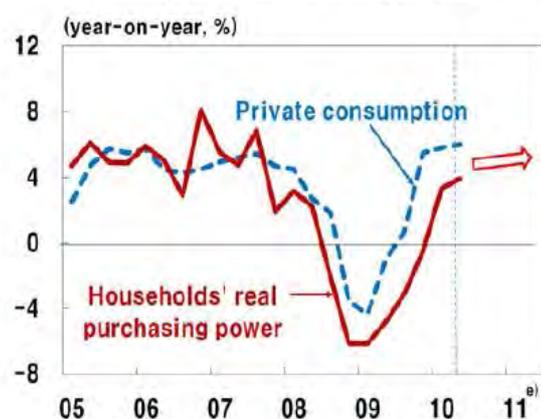
Household consumption

Household purchasing power is forecast to expand thanks to higher incomes resulting from the continued economic upswing.

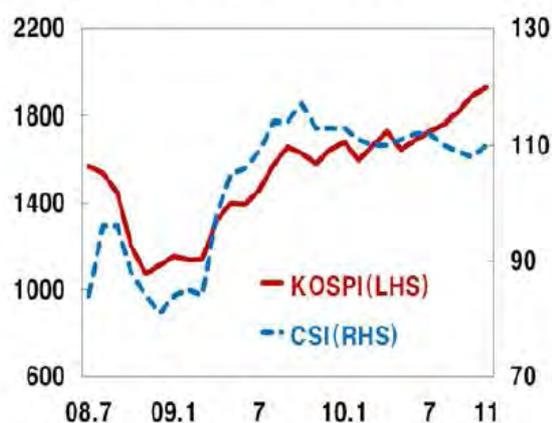
- Households are also expected to become more consumption-minded.
 - Share prices, which form a leading indicator of consumer sentiment, have risen strongly since this September.⁶

Having said this, the worsening of the terms of trade, could act as a factor limiting the increase in consumption.

Households' real purchasing power¹⁾ and private consumption



KOSPI and consumer sentiment index



Note : 1) Real wage \times number of persons employed

Corporate investment

Even in 2011, conditions for corporate investment are expected to present a comparatively favorable picture as growth trends are maintained in major branches of industry while capacity utilization rates run at high levels.

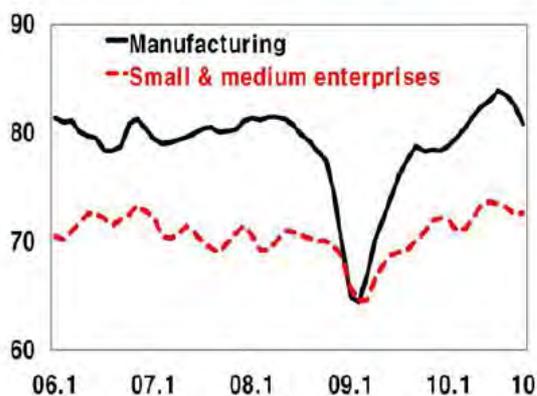
- World demand for IT products and cars is increasing continually while domestic demand is also buoyant owing to the effect of new products such as smartphones.

Construction investment, though, is likely to remain sluggish.

- In the housing market, although there is some likelihood of private sector housing construction picking up as it shows signs of shaking off its long time torpor, the public sector, for its part, is predicted to present a subdued picture in line with this year's large-scale reduction in permits issued.

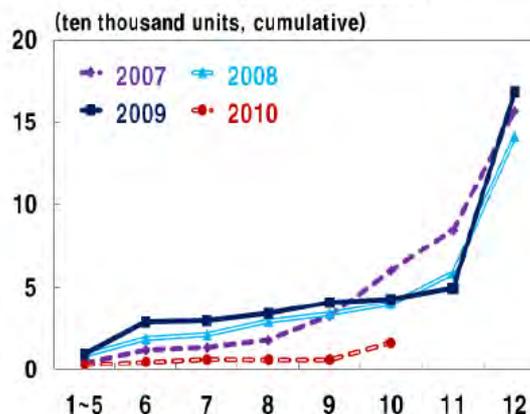
⁶ It is estimated that the rise in share prices during the first three quarters of this year added some 44 trillion won to the stock of financial assets.

Average operation ratio¹⁾ of manufacturing



Note : 1) 3-month moving average

Housing construction permits in the public sector



Source : Ministry of Land, Transport and Maritime Affairs

II. Main assumptions & economic outlook

1. Main assumptions of the forecasts

The growth of the world economy next year is set at 4.0%, reflecting the economic conditions in major countries (4.3% in 2012).

The rate of the expansion of world trade is assumed to be 6.7% (7.3% in 2012).

The price of a barrel of crude oil (annualized average) is set at USD 87 per barrel (USD 90 in 2012).

Main assumptions

	2010 ^{e)}	2011 ^{e)}			2012 ^{e)}
		H1	H2	Year	
▪ Global economic growth(%) ¹⁾	4.6	3.8	4.1	4.0	4.3
USA	2.8	2.3	2.6	2.4	3.1
Japan	3.5	1.0	1.0	1.0	2.2
Eurozone	1.7	1.6	1.4	1.5	1.9
China	10.3	9.1	9.3	9.2	9.0
▪ Global trade growth(%) ¹⁾	10.5	6.2	7.2	6.7	7.3
▪ Oil import unit price (US dollars per barrel) ²⁾	79	89	85	87	90
▪ Increase in other commodity prices(% ¹⁾	21.0	10.0	-3.0	3.0	6.0

Notes : 1) year-on-year(%)

2) Proportion of oil imports : 80% from the Middle East, 20% from other regions, period average, CIF basis

2. *Economic outlook*

Growth

The GDP growth rate in 2011 is forecast to register 4.5%.

- In terms of each half year, it is expected to accelerate over the course of the year, running at 3.8% in the first half and 5.0% in the latter half.
- For 2012, it is forecast to rise to 4.7%.

Let us now look at the details of growth next year by sectors of expenditure.

- Private consumption is predicted to increase constantly in line with the expansion in household purchasing power (4.1% in 2011 and 4.3% in 2012).
- Facilities investment, similarly, should mark a solidly-based upward trend, but the scale of its increase is expected to narrow owing to the completion this year of the majority of investment projects held over because of the financial crisis (6.5% in 2011 and 6.3% 2012).
- Construction investment is expected to stage no more than a slight increase (1.4% in 2011 and 1.3% in 2012).
- Exports are forecast to continue on their strongly upward track, boosted by the advanced countries' sustained recovery mode and the strong growth being registered in the newly emerging countries (9.6% in 2011 and 12.5% in 2012).

Outlook for economic growth

(year-on-year,%)

	2010			2011 ^{e)}			2012 ^{e)}
	H1	H2 ^{e)}	Year ^{e)}	H1	H2	Year	Year
GDP	7.6	4.6	6.1	3.8	5.0	4.5	4.7
Private consumption	5.0	3.4	4.2	3.8	4.5	4.1	4.3
Facility investment	30.1	19.5	24.3	9.5	3.9	6.5	6.3
Construction investment	-0.7	-2.1	-1.5	0.1	2.5	1.4	1.3
Goods exports	17.9	14.5	16.1	11.5	8.0	9.6	12.5
Goods imports	21.9	18.9	20.3	12.3	8.2	10.1	11.1

Employment

The number of persons in employment is forecast to rise by 260,000 in 2011 and by 280,000 in 2012.

- The unemployment rate should drop from 3.8% this year to around 3.5% next year.

	<u>2010 H1</u>	<u>H2</u>	<u>Year</u>	<u>2011 H1</u>	<u>H2</u>	<u>Year</u>	<u>2012</u>
Changes in the number of persons employed (ten thousand)	28	37	33	29	22	26	28
Unemployment rate (SA, %)	3.9	3.6	3.8	3.6	3.3	3.5	3.4

Prices

Consumer price inflation is seen to accelerate to 3.5% in 2011 and to rise about 3.2% in 2012.

- The rate of core inflation, similarly, will edge up above 3% from next year.

	<u>2010 H1</u>	<u>H2</u>	<u>Year</u>	<u>2011 H1</u>	<u>H2</u>	<u>Year</u>	<u>2012</u>
Consumer price inflation	2.7	3.2	2.9	3.7	3.3	3.5	3.2
Core inflation	1.7	1.9	1.8	2.8	3.3	3.1	3.1

(year-on year, %)

Current account

The current account surplus for 2011 is expected to narrow in scale from this year's 29 billion dollars to 18 billion dollars.

- For 2012 it is forecast to be around 16 billion dollars.

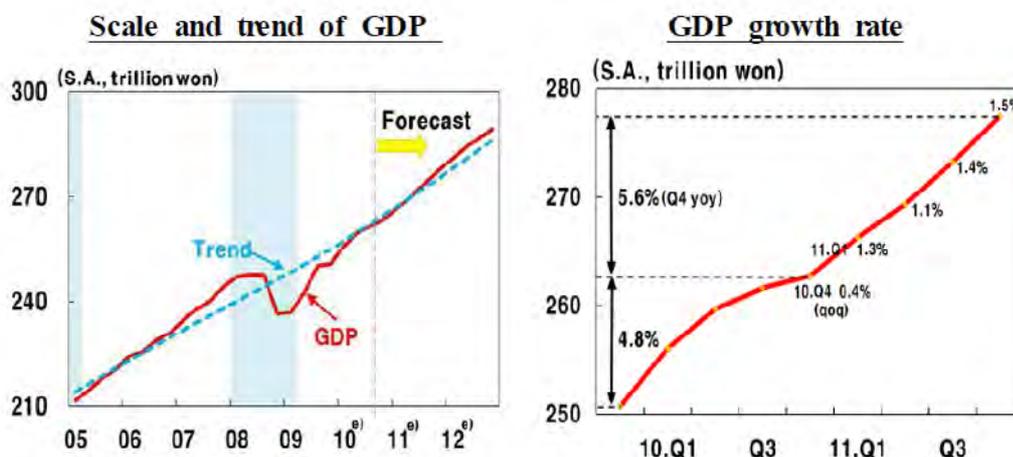
	(100 million dollars)						
	2010			2011 ^{e)}			2012 ^{e)}
	H1	H2 ^{e)}	Year ^{e)}	H1	H2	Year	Year
Current account	89	200	290	70	110	180	160
Goods account	171	237	408	150	165	315	300
Services ¹⁾ account	-81	-37	-118	-80	-55	-135	-140

Note: 1) Including primary and secondary income account

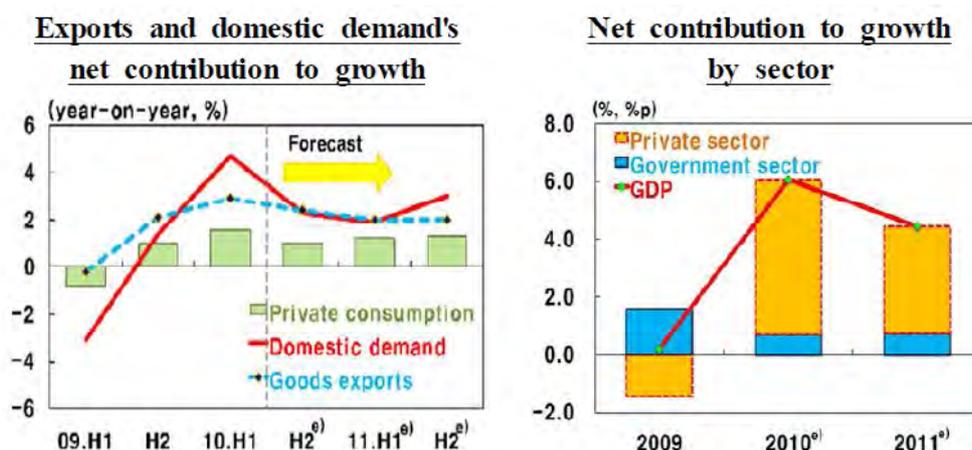
III. Overall assessment & policy tasks

Overall assessment

1. Next year's GDP growth rate of 4.5% will be at the trend level⁷.
- The trend of an increase in economic activity should continue as next year's Q4 growth (year-on-year) is projected at 5.6%, well above this year's 4.8%.



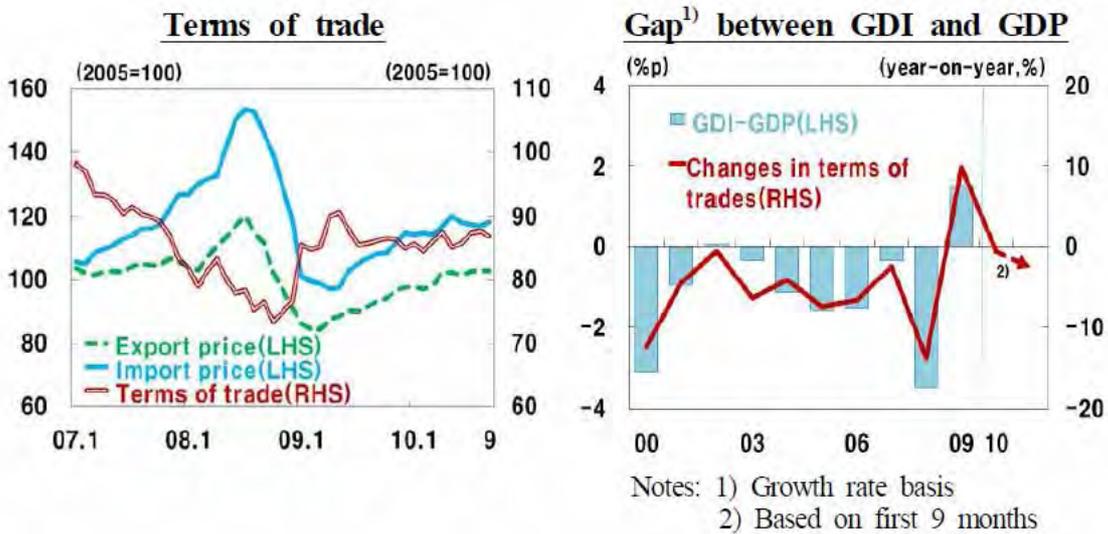
- In terms of expenditure sectors, domestic demand and exports are likely to act as twin sources of growth owing to the strengthening of private consumption and facilities investment.
 - The net growth contribution of domestic demand⁸ will be 2.5% and that of exports 2.0%.
 - The government's net growth contribution will be at the level of 0.7 percentage point, the same as in an average year (2001~07 average: 0.7%p).



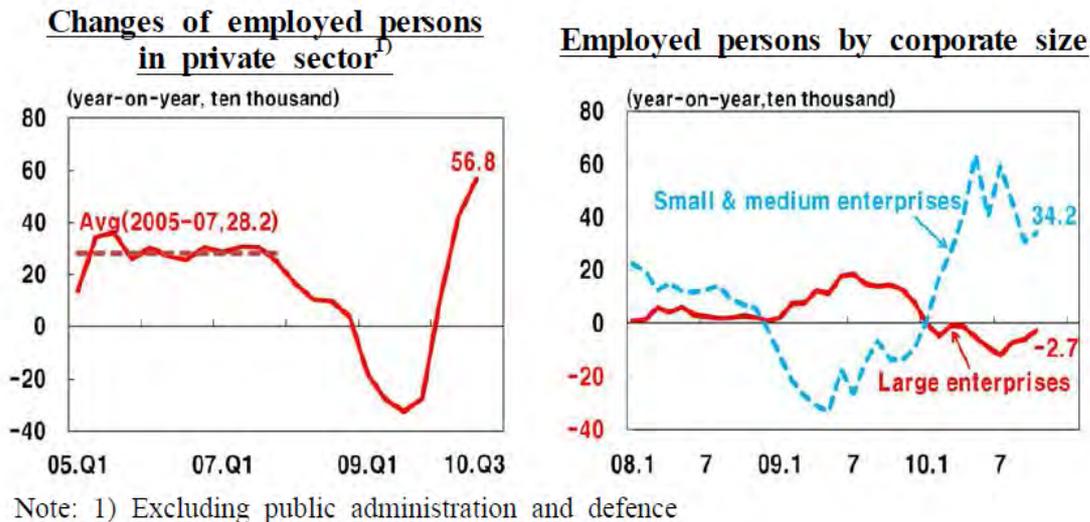
⁷ This year's 6.1% figure was greatly influenced by the base-period effect during the course of overcoming the global financial crisis.

⁸ The figures are calculated first by computing the scale of imports induced by domestic demand and exports using the import generation coefficient of the industrial input-output tables by sectors. The scale of imports is then subtracted from the relevant sector.

- The perceived level of economic activity is expected to improve further as the growth contribution of domestic demand increases, but it is likely to be difficult to narrow significantly its differential from the actual level of economic activity.
 - The rate of increase of gross domestic income (GDI) will trail that of economic growth because of the worsening of the terms of trade.



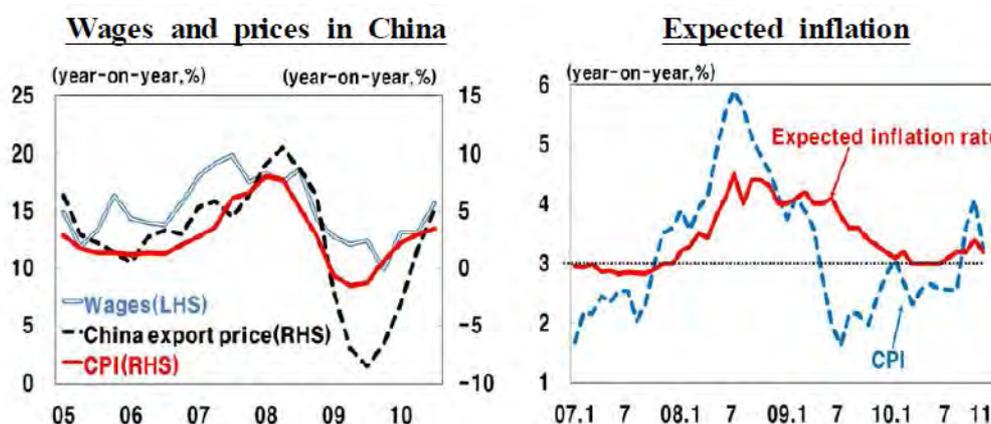
2. In the labor market, the trend of improvement will be maintained with a private-sector-led increase in the number of persons employed and a fall in the unemployment rate.
 - Having said that, the degree of improvement in qualitative terms will be checked somewhat by the febleness of large businesses in the creation of what are seen as “decent jobs”⁹.



3. Consumer prices are expected to stay on a rising track for quite some time, carrying over from the 3 1/2% level for this quarter.

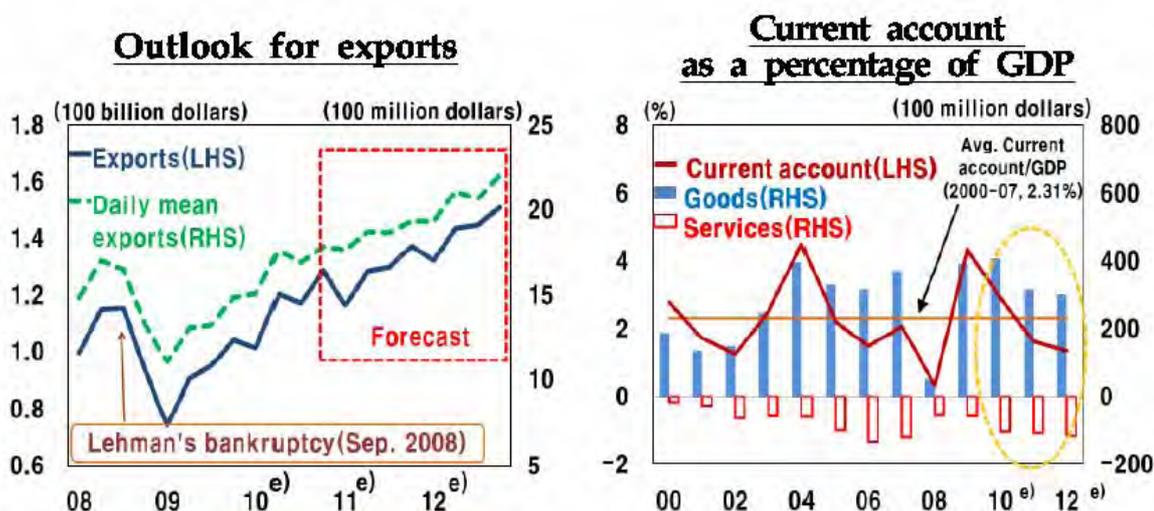
⁹ Even as the number of persons employed in the private sector increased by a total of 382,000 running up to October of this year, that of large corporations decreased by 49,000.

- Demand pressures are being built up from the sustained rise in economic activity and international commodity prices, wages and rental charges are all on the rise.
- The accelerated upward trend of Chinese wages and prices may also act as a cost push factor for domestic prices by way of higher import prices.
- Expected inflation, which has been on the rise since the beginning of this year, will affect prices after some time lag.



4. The current account will retain its underlying surplus but the scale of this surplus is seen to shrink owing to the expansion of imports drawn in by the strengthened recovery momentum of domestic demand.

- The ratio of the current account surplus to GDP will drop from this year's 3% level to below 2.0% but above 1.5% in 2011.



5. These economic forecasts for 2011 are attended by a considerable degree of uncertainty. Domestically, there are the geopolitical risks following the North Korean attack on Yeonpyeongdo. Externally, the unknowns include the sovereign debt problems of the euro area, price instability in China, and the direction of the US Fed's monetary policy post-QE2.

Policy tasks

1. While the Korean economy will stay on a solid growth track in 2011, political initiatives should be directed toward raising the living conditions of the public at large including the boosting of purchasing power by way of price stability and the creation of “decent jobs”, given the persistent gap between public perceptions of the level of economic activity and the actual numbers.
2. Great care must be taken to avoid an enfeebling influence on the domestic financial and foreign exchange markets and on real economic activity from the eurozone debt problems, Chinese inflation and the Fed’s monetary policy course post-QE2.
3. In order to respond to an increase in the level of uncertainty of the external environment, a policy mix should be devised that emphasizes the twin growth pillars of domestic demand and exports.